

Mary G. Sullivan  
Corporate Counsel  
Central Region

October 15, 2007

Ms. Elizabeth A. Rolando  
Chief Clerk  
Illinois Commerce Commission  
527 East Capitol Avenue  
Springfield, IL 62701

RE: Docket No. 06-0336

Dear Ms. Rolando:

We are providing an October 12, 2007 credit report from Moody's Investors Service.

If I can be of further assistance, please let me know.

Very truly yours,



Mary G. Sullivan  
Corporate Counsel

cc: Mary Selvaggio

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**Rating Action: American Water Capital Corp. (New)****Moody's Downgrades American Water to Baa2; Confirms P-2 Short-Term Rating**

New York, October 12, 2007 – Moody's Investors Service today downgraded to Baa2 from Baa1 the senior unsecured issuer rating of American Water Capital Corp ("Capital"). Moody's also confirmed Capital's P-2 short-term rating. At the same time, Moody's assigned a (P) Baa2 senior unsecured rating to Capital's planned \$1.5 billion note offering and a Baa2 senior unsecured issuer rating to Capital's parent, American Water Works Company, Inc ("American Water"). The rating outlook for both issuers is stable. Today's rating action concludes the review for possible downgrade initiated on August 28, 2007.

Moody's review of Capital's short and long-term ratings was prompted by American Water's planned recapitalization of the company in advance of the divestment, via initial public offering, from its current parent, RWE AG (A1 stable). The initial sale of RWE's interest in American Water is expected to happen in late 2007; however, preceding that transaction, Capital is expected to issue \$1.5 billion of senior unsecured notes in order to substantially repay approximately \$2.0 billion of inter-company debt currently owed to RWE. These notes are expected to be issued in October 2007. It is Moody's understanding that the company will also issue \$500 million of "equity units" concurrent with the IPO that will fund out the balance of inter-company debt owed to RWE.

The one-notch downgrade of Capital's senior unsecured issuer rating, and the assignment of a Baa2 issuer rating to its parent, American Water, reflects the loss of implied support from RWE following the IPO, historically weak consolidated credit metrics, and the increase in financial and operating risk going forward as a publicly traded stand-alone company. Moody's has also taken this opportunity to equalize the new rating for American Water, a holding company, with its finance subsidiary, Capital, due to the existence of a "support agreement" between the two entities that effectively backstops Capital's timely payment of principal and interest, as needed. Nevertheless, an additional concern is that approximately 60% of American Water's consolidated debt will be borrowed at Capital, with the balance at the various regulated operating subsidiaries where the material cash flows are generated. We note that debt at Capital does not benefit from any upstream guarantees from the regulated utility operations nor does the debt obligations of the subsidiaries, including Capital, benefit from any downstream guarantee from American Water.

Moody's considers American Water's position as the largest investor-owned water utility in the U.S. and geographic diversity with regulated operations in 20 states as being positive credit qualities. Moody's views investor-owned water utilities in the U.S. as having greater long-term stability and supportive regulatory treatment than most of their electric utility counterparts which has resulted good levels of historical cash flow from such regulated operations. Although American Water's cash flow derived credit metrics have exhibited weakness for some time and are considered somewhat soft for the Baa2 rating (funds from operations (FFO) to total adjusted debt was approximately 7.5% for the trailing twelve month period ended June 30, 2007), Moody's believes there is capacity for improvement as the company has either filed or is planning to file for rate increases in all of the jurisdictions in which it operates after a long period following RWE's acquisition where the company's ability to increase rates was limited due to stay-out provisions agreed to in some jurisdictions. Timely rate increases and the ability to attract new equity capital will be two key drivers for maintaining the rating going forward as the water utility industry remains capital intensive with infrastructure spending often times at a multiple of depreciation. American Water is facing a sizeable capital spending plan and will need to finance additional rate base with debt and equity at levels appropriate for the rating category to avoid future downward pressure on the rating or outlook given the magnitude of the planned expenditures.

We note that American Water also has a much smaller non-regulated water-related services segment (approximately 12% of fiscal 2006 revenues) that will remain a part of its business model going forward. While this business segment is considered a growth area and is less capital intensive, it is also less profitable. Consequently, the regulated operating subsidiaries will continue to be the primary source of funds to service debt and to pay the expected dividends to its public shareholders.

The stable outlook reflects Moody's expectations that going forward there will be no material change to the currently envisioned capital structure. The refinancing will likely have a negative impact on American Water's financial flexibility going forward as the company terminates its historical reliance on funding from its larger and more financially secure parent and switches to meeting those capital needs from the public debt and equity markets as a standalone entity. Moody's expects the company to maintain adequate liquidity for its operations primarily through Capital's \$700 million commercial paper program which is currently backstopped by a committed multi-year \$800 million revolving bank facility expiring in September 2012. Although currently lightly drawn, Moody's expects the company may moderately increase its utilization of commercial paper borrowings over the balance of 2007.

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COMMERCIAL CREDIT

Headquartered in Voorhees, New Jersey, American Water Works Company, Inc. is an indirect wholly-owned subsidiary of RWE AG and is the largest investor-owned provider of water, wastewater and related services in North America. It is the parent company of numerous water utilities in the United States and reported revenue in 2006 of \$2.1 billion.

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